

Rating Update: MOODY'S AFFIRMS Aa2 ISSUER RATING AND NEGATIVE OUTLOOK ASSIGNED TO THE STATE OF ARIZONA; STATE APPROPRIATION DEBT RATINGS ALSO AFFIRMED

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AFFIRMATIONS AND NEGATIVE OUTLOOK APPLY TO ABOUT \$2.4 BILLION IN OUTSTANDING DEBT

State
AZ

Opinion

NEW YORK, May 6, 2010 -- Moody's Investors Service has affirmed the State of Arizona's issuer rating of Aa2. Additionally, Moody's has affirmed the Aa3 rating assigned to state general fund appropriation-backed debt, which includes state appropriation-backed debt issued by the state, the Arizona School Facilities Board and the Industrial Development Authority of Phoenix; and the A2 rating assigned to the appropriation-backed debt issued for the Arizona Game and Fish Department and Commission. The rating outlook is negative.

The state's issuer rating reflects Arizona's economic and financial weakness, leading to significant revenue underperformance, sizable budget deficits, depletion of reserves, reliance on non-recurring budget solutions causing significant structural budget imbalance, and tightening of liquidity in the current fiscal year. Also reflected are limits on the state's financial flexibility including federal government mandates related to Medicaid funding as well as voter initiated spending mandates and a requirement for a 2/3 majority vote of the state legislature or vote of the people to increase revenues. Due to enacted expenditure mandates, tax cuts, a significant slide in the housing market, and an increasing reliance on non-recurring budget solutions including the issuance of deficit bonds, state budget deficits and structural imbalance have grown materially since fiscal 2009. We expect that the state will lag in the economic recovery as it will take some time to rebound from the severe housing market downturn. Until the economy rebounds, the state will continue to experience fiscal pressure which will be difficult to address given constraints on the state's financial flexibility. A recent Arizona boycott called for in the wake of adopted immigration legislation threatens to reduce tourism and have a potential negative impact on the state's sales tax revenue.

The state has already taken measures that were largely nonrecurring in nature to balance the current year budget and has enacted a fiscal 2011 budget that dealt with a budget deficit of over \$3 billion or about 34% of the budget through both nonrecurring and ongoing budget measures. Fiscal 2011 budget measures, however, include items such as a temporary 3-year increase in the state's sales tax expected to result in \$918 million in increased annual collections and a redirection of certain funds, estimated at about \$500 million, into the state's general fund, that are contingent on voter approval. Contingency budget reductions (\$862 million) are planned in the event that the sales tax ballot measure fails, although there are no contingency measures outlined in the event that the other ballot measures fail. In the enacted fiscal 2011 budget, the state had implemented cuts affecting certain Medicaid populations, but has now rescinded those cuts contingent on Congressional approval of an extension of temporary increases in federal matching funds for Medicaid through June 30, 2011. The rescission of the cuts was necessary because recently passed federal healthcare reform legislation requires states to maintain the same Medicaid populations existing as of the enactment date of the legislation in order to continue receiving federal Medicaid matching funds.

The state has made significant strides in addressing the current year budget gaps and in enacting a fiscal 2011 budget that featured more recurring measures, including spending cuts and the potential 3-year tax increase. Uncertainties, however, still remain for the state's finances, including the unknown outcomes of ballot initiatives, partial contingency planning that may be challenging to implement because it focuses heavily on education cuts, and expectations of an extension of the temporary increase in Medicaid funding that has not yet been enacted. The state faces these issues in the context of a weakened economy and uncertainty regarding the timing of an economic recovery. These factors will continue to pose challenges as the state strives for financial stability.

Credit strengths:

- History of positive ending fund balances
- Moderate, albeit increasing debt levels
- Strong population growth, at better than national levels

Credit challenges:

- Economic and revenue slowing, reflecting weakness in the state's housing sector that has strained state finances and led to significant budget deficits and liquidity strain
- Significant reliance on nonrecurring resources to balance state budgets
- Negative impact of voter initiatives and statutory and constitutional constraints on financial flexibility
- Lack of institutionalized best financial management practices

SIGNIFICANT REVENUE SLOWING LEADS TO SIZABLE BUDGET GAPS; RESERVES DEPLETED

Arizona's revenues have been hurt by the national economic downturn, as they have been in nearly every other state. Following strong general fund revenue growth from fiscal 2004 through fiscal 2007, growth began to slow considerably in fiscal 2008 and recurring revenues ultimately declined by about 8%. Driven by a continued and severe housing market downturn that negatively affected all major revenue categories, revenues for fiscal 2009 dropped further, with a decline in recurring revenues of nearly 21%. Individual and corporate income taxes each declined by over 24% in fiscal year 2009, while sales taxes, the largest state-source revenue in Arizona, declined by nearly 14%. Currently, the state is projecting a decline in revenue growth for fiscal 2010 of about 9%. Projections for fiscal year 2011 indicate growth of about 7% off a lowered base, though this may be optimistic given job losses and the potential impact of recent calls for a boycott of the state precipitated by the recent adoption of state immigration legislation.

The recently enacted immigration-related legislation has resulted in calls for an economic boycott of the state from various groups. While it is unclear what the ultimate impact will be, the state is seeing some cancellations of planned business meetings. Reductions in business visitors and tourism in general could have a significant negative impact on sales-tax dependant state finances.

As a result of revenue deterioration, the state has been forced to address significant consecutive budget deficits. The state initially estimated the fiscal year 2010 budget gap at about \$3.6 billion. In September 2009, after the conclusion of a special legislative session, the governor signed legislation that addressed about \$3.2 billion of the fiscal year 2010 gap. Gap closing measures included \$630 million in expenditure reductions, but relied heavily on federal stimulus funds (\$1.1 billion) and issuance of debt for budget relief (\$735 million). Other one-time measures included fund sweeps and agency payment deferrals. The remaining gap, after consideration of these actions, was then estimated at about \$1 billion, but grew to about \$2 billion by November as revenues continued to weaken. Additional actions were taken from that point through March 2010, when the fiscal 2011 budget was enacted, to resolve the remaining fiscal 2010 deficit. While these solutions for fiscal 2010 did include some expenditure cuts, they relied extensively on one-time measures including additional issuance of deficit bonds (\$750 million) and K-12 and higher education payment delays (\$450 million) into the next fiscal year.

The fiscal 2011 budget, enacted in March 2010, dealt with an initial gap estimated at over \$3 billion. In addition to cuts in spending, fiscal 2011 budget balance relies on the passage of a ballot initiative on May 18th that would increase the state's sales tax by one cent per dollar for three years, providing an estimated \$918 million in increased annual collections. If the ballot measure fails, contingent expenditure cuts (\$861 million) have been enacted, primarily affecting education. The budget also assumes passage of two additional ballot measures in November, resulting in about \$500 million in revenues redirected to the state's general fund from a land conservation fund and from tobacco tax moneys currently funding an early-childhood education and health coverage program. If these measures fail, the state will need to take action to address the gap, as no contingency measures have been identified. The enacted fiscal 2011 budget also relies on substantial ARRA stimulus funding (about \$600 million) and expects an extension of ARRA to cover the approximately \$400 million associated with Medicaid cuts in the enacted budget that cannot be implemented under new federal healthcare reform legislation without endangering ongoing federal Medicaid funding for the state.

State actions to cover fiscal 2010 budget gaps relied heavily on one-time resources, resulting in a significant structural budget imbalance. For fiscal 2010, this imbalance, excluding federal stimulus funding, was over \$3.5 billion or about 58% of recurring revenues. The fiscal 2011 budget features an ongoing structural imbalance, but at a much lower level - at over 20% of recurring revenues.

The state's Budget Stabilization Fund balance totaled \$673.5 million at the end of fiscal 2007. Since then, stabilization fund moneys have been used to help cover fiscal 2008 and fiscal 2009 budget deficits, depleting the balance. There are no immediate plans to replenish reserves.

STATE CASH POSITION WEAKENED

Arizona's general fund cash balances have weakened considerably in fiscal 2010. Prior to the fiscal 2010 budget gap measures enacted from the end of 2009 through March of this year, daily operating cash low point deficit balances of over negative \$900 million were projected in mid-January and mid-April. The expected year-end fiscal 2010 balance was projected at positive \$362 million. The actual year-to-date low point for fiscal 2010, however, was a lower deficit balance of about negative \$733 million and, going forward to the end of the fiscal year, current projections indicate a daily cash low point deficit balance of about negative \$607 million, with a positive ending balance of about \$1.3 billion. Current improved projections reflect the effects of the fiscal 2010 budget solutions which included K-12 and higher education payment delays from fiscal 2010 to fiscal 2011 and significant deficit bonding for budget relief.

While the state's cashflow situation has improved for fiscal 2010, projections indicate potential monthly deficits for certain periods during fiscal 2011. Fiscal 2011 cashflow will ultimately be affected by the outcome of proposed ballot initiatives. Based on current projections, expected available resources are projected to be sufficient to cover cash needs. Internal resources available for borrowing to cover cashflow needs are estimated at about \$550 million. Up to an additional \$550 million could be made available if the state Board of Investments were to alter its policy on available borrowable resources. The state has also established a bank facility of up to \$700 million for its Treasurer's Warrant Notes (TWNs). TWNs are short-term notes whose repayment has a first lien on state general fund revenues. The bank facility expires on June 30th, but the state is expecting to extend it for fiscal 2011 at the same level of funding.

In the past, the state never needed to borrow externally for cashflow, relying instead solely on internal resources. However, during fiscal 2010, weakened cashflows have led to use of the entire bank line and borrowing from internal resources as well. The state also has the ability, which it has utilized this year, to delay state aid payments to improve cashflow.

STATE ECONOMY NEGATIVELY AFFECTED BY HOUSING DOWNTURN

After strong growth in recent years that outpaced the nation, Arizona's economy has slowed considerably. State non-farm payroll employment experienced annual growth of 4% to 5% in 2004 through 2006 before falling to 1.5% in 2007 and declining by 2.1% in 2008 and 7.3% in 2009. Preliminary figures for March 2010 reflect a year-over-year job decline of 3.3%, vs. 1.7% for the nation. The significant slowing reflects the impact of a weakened housing sector, which can be seen particularly in the state's construction employment. After three years of strong growth averaging 11%, figures for 2007 show a 6.4% decline in construction jobs, followed by declines of 17.3% in 2008 and 30.8% in 2009. Preliminary figures for 2010 show a March year-over-year construction job decline of 19.9% vs. 11.1% for the nation. The impact of the housing downturn on the state's economy and finances has been significant, leading to a recovery period that will likely be longer than most states.

Arizona's population growth between 1990 and 2000 was about 40%, compared to 13% growth for the U.S. as a whole. Strong growth has continued, with the state's population expanding by 27% between 2000 and 2008, almost 3.5 times the 8% national rate during that period. While this trend has benefited the state's economy and finances, it also places pressure on the state for educational, health and human services, and public safety costs.

Despite continued annual personal income growth in recent years, the state's personal income per capita is below the national level. Arizona's personal income per capita was about 85% of the U.S. figure in 2008, down from 87% in 2007. State poverty levels are higher than national figures. Based on U.S. Census data for 2007, the state is ranked 11th in percent of people in poverty (14.3%) that exceeds the national level (12.5%).

FINANCIAL FLEXIBILITY LIMITED

Fiscal planning for the state has been traditionally challenged by statutory and other limitations. These factors have introduced an above average degree of inflexibility to state finances. In the 1990s, voter approved initiatives resulted in an amendment to the constitution requiring either a 2/3 vote of the legislature or a vote of the people to increase state revenues and a mandate that voter approved programs cannot be modified by the state legislature. Subsequent voter approved programs that either increased expenditures or directed funding for specific purposes were thereafter protected from spending cuts or redirection of program funds. These included programs that expanded health coverage requirements and funding for education programs.

Additional weakness in the state's governance and financial management profile relate to budgeting policies and revenue and expenditure forecasting. There is no statutory authority for the governor to enact mid-year expenditure reductions should revenue trends or unexpected expenditure needs indicate a budget imbalance. The governor may direct agencies to hold back on spending, with such unspent monies reverting to the general fund at year end, but actual reductions in appropriations require legislative approval. While an informal process of consultation does occur, no formal, statutory requirement for consensus revenue forecasting (including both executive and legislative branches) currently exists. In general, executive and legislative forecasts have been close, but there have also been instances of larger (as much as \$300 million for fiscal year 2004) variance. The state currently does not produce a formal multi-year state revenue and expenditure or debt forecast.

ARIZONA DEBT LEVELS REMAIN NEAR STATE DEBT MEDIANS

Arizona does not issue general obligation bonds. Instead, the state issues appropriation-backed lease debt, largely related to school construction, and revenue bonds, including the Arizona Transportation Board's Highway Revenue Bonds, Grant Anticipation Notes, and Transportation Excise Tax Revenue Bonds. The state has also issued sales tax bonds in support of school capital needs. The state has no variable rate debt outstanding.

Based on Moody's 2009 State Debt Medians report, Arizona ranked 29th among states for net tax-supported debt per capita and 25th for net tax-supported debt as a percent of personal income. State net tax-supported debt per capita was \$807, as compared to a state median of \$865. Debt, as a percentage of personal income, was 2.5%, equal to the state median. State debt levels will increase as the state plans on issuing more debt for budget relief. As part of the 2010 budget gap solution, the state issued \$709 million in state certificates of participation for budget relief and expects to issue another \$750 million in additional deficit bonds before the end of the fiscal year.

As of the most recent valuation dates, state retirement systems were about 80% funded. This funded ratio is expected to decline, as with all other states, due to stock market losses in 2008 and 2009. Funded levels are based on 6/30/08 data for the state's largest retirement plan. Arizona does not provide an OPEB liability figure as state audits have concluded that the state's liability - which reflects only an implicit rate subsidy -- is immaterial. The state does not pay for retirees' health benefits, but the subsidy reflects the fact that retirees are offered the same benefits as state employees and at the state's group rates, which the retirees pay in full.

RECALIBRATION OF RATING TO THE GLOBAL RATING SCALE; PRINCIPAL METHODOLOGY

The Arizona ratings that were affirmed are issued on Moody's global rating scale. Market participants should not view the recalibration of municipal ratings as rating upgrades, but rather as a recalibration of the ratings to a different rating scale. This recalibration does not reflect an improvement in credit quality or a change in our credit opinion for rated municipal debt issuers. For further details regarding the recalibration of Moody's U.S. municipal ratings to its global scale please visit www.moody.com/gsr.

The principal methodology used in rating the current issue was Moody's State Rating Methodology published in November 2004 and available on www.moody.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating the State of Arizona can also be found in the Rating Methodologies sub-directory on Moody's website.

LAST RATING ACTION

The last rating action with respect to the State of Arizona was on December 22, 2009, when the state's municipal scale Issuer Rating was downgraded from Aa3 to A1, state general fund appropriation debt municipal scale ratings were downgraded from A1 to A2, and the municipal scale rating for appropriation-backed debt issued for the Arizona Game and Fish Department and Commission was downgraded from A3 to Baa1.

Outlook

The rating outlook for the State of Arizona is negative. The state is experiencing a serious economic slowdown which, together with tax reductions implemented in 2007 and various spending mandates, has resulted in ongoing, significant fiscal stress and tightening liquidity. While Arizona is acting to stabilize its fiscal situation, diminished state resources, economic uncertainty, uncertainty regarding proposed budget measures, unknown cumulative effect on revenues from the state boycott, and inflexibility related to spending mandates and revenue raising requirements pose considerable challenges to a return to fiscal stability.

What could change the rating - UP

- A return to long-term economic and financial growth
- Improved liquidity
- Restoration and maintenance of structural balance in state finances and limited reliance on non-recurring resources
- Restoration and maintenance of reserves
- Implementation of institutionalized best financial management practices

What could change the rating - DOWN

- Continued, significant economic slowing or recovery that lags other similarly-rated credits

- Weakened revenue performance and additional liquidity strain
- Ongoing budget imbalance and reliance on one-time resources
- Reserves remain depleted, with no viable plans to replenish
- Failure to adopt timely, viable solutions to address any potential fiscal year 2011 budget shortfalls
- Failure to adopt a fiscal plan that will maintain budget balance when federal fiscal stimulus dollars are no longer available

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